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The Manufacturers Hanover
Economic Report

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Chief Economist

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Curves

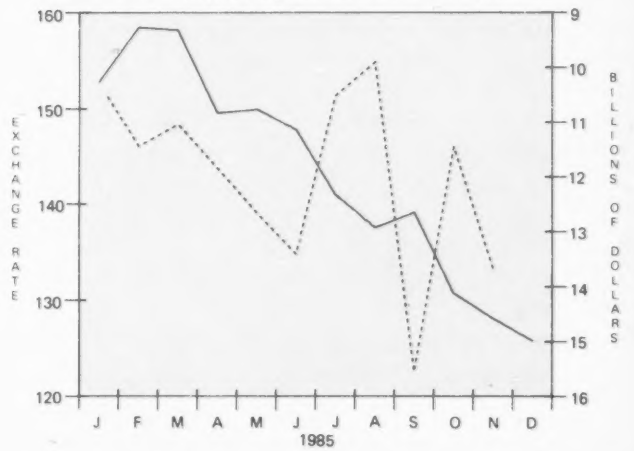
Economists are fond of using curves to describe the behavior of consumers, businessmen, and markets. Leafing through several of my textbooks the other day, I came up with a variety of curves. There are yield curves, demand curves (regular and kinked), supply curves (regular and backward bending), indifference curves, cost curves (average and marginal, short- and long-run), product curves, revenue curves and market equilibrium curves, just to name a few. These curves are probably arcane to most noneconomists, however important they may be. But there are three curves that have made their way into the common lexicon because they have become useful tools for policymakers. Indeed, these curves are so much a part of our economy today that they warrant a discussion at this time.

The J Curve

No doubt the curve that everyone is keeping a close watch on today is the J curve. This is because it deals with the reaction of our balance of trade to a change in the value of the dollar in foreign exchange markets. As readers know by now, because of the sharp climb in the value of the dollar between July 1980 and late February 1985, our merchandise trade balance was driven into the red by an unprecedented amount. After running a surplus throughout most of the 1960s, our merchandise trade balance slipped into deficit in the early 1970s, but even as recently as early 1983 was not more than $10 billion in the red on a quarterly basis. Since then, however, it has been all downhill, with the latest reading showing a quarterly deficit in excess of $33 billion, or an annual rate of $132 billion.

Now that the dollar is down by nearly 25 percent against the currencies of our major trading partners compared with late February 1985, a number of observers have come to believe that the trade deficit will narrow this year compared with last (Economic Report—December 1985). Indeed, such a narrowing—

CHART I
U.S. DOLLAR TRADE WEIGHTED EXCHANGE RATE <MAR. 1973=100> (LINE) VS. MERCHANDISE TRADE DEFICIT, INVERTED SCALE (DOT)



or, at the very least, no further widening—of the trade deficit is critical to those forecasts which project better growth this year than in 1985. This is because the trade deficit, as it widened, subtracted a considerable amount from economic growth.

It is reasonable to expect the trade deficit to shrink now that the dollar is down. This is because foreign-made goods will be marked up in price, reflecting the rise in foreign currencies compared with the U.S. dollar. At the same time, goods produced in the U.S. intended for sale abroad will become more competitive if exporters follow the dollar down and adjust their prices in foreign currencies accordingly. Notwithstanding this logic, the first reaction of our trade deficit to the decline in the value of the dollar was a widening rather than a shrinking (Chart I). This is what is known as the J curve effect. It stems from the fact that, in the wake of a decline in the value of the dollar, imports go up in price faster than the demand for imported goods falls. This becomes the downward slope of the J. After a while, higher import prices will depress import demand, causing a slowing in the dollar value of imports.

The same is true for exports. They do not rise immediately following a drop in the value of the dollar.

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This is due to the fact that much of our exports are covered under contracts which may have already fixed prices and quantities. In addition, as the December Economic Report observed, much of our exports are in big-ticket capital goods which take many months to move from orders to deliveries. Once deliveries are made and new contracts are negotiated, they will reflect the lower dollar price and exports will begin to rise. As exports rise and imports fall, our trade balance will trace the upward slope of the J and will narrow.

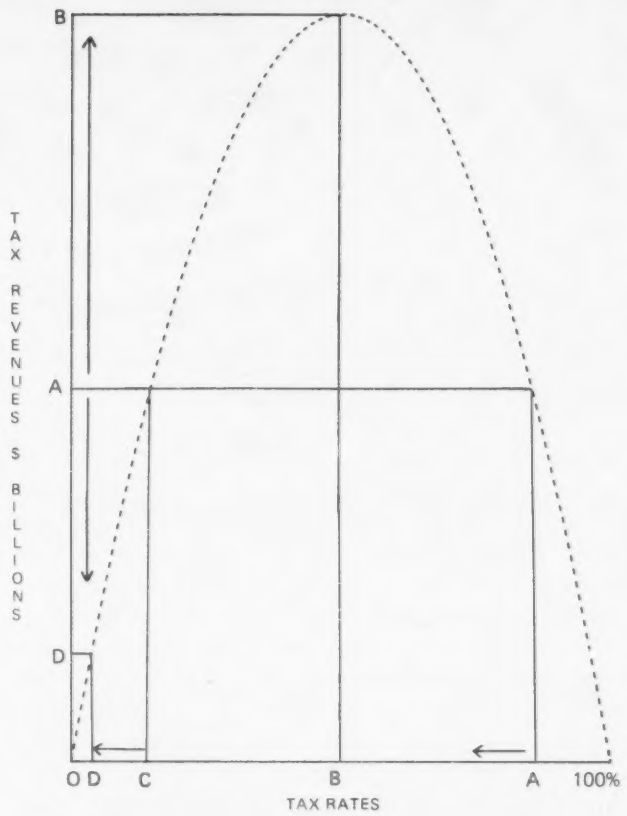
The Laffer Curve

Just as the J curve is very much in the spotlight today, so the Laffer curve was center stage a few years ago. It takes its name from the economist Arthur B. Laffer, who is said to have first drawn the curve on a napkin in a Washington D.C. restaurant in 1974. He was trying to illustrate the proposition that there are always two tax rates that yield precisely the same revenues. As you can see from Chart II, those tax rates are zero and 100 percent. When taxes are 100 percent, the government collects no tax revenues because people will not work in a money economy if all the fruits of their labor are confiscated by the government. At the other extreme, it is also clear that if the tax rate is zero and people keep 100 percent of the revenues they receive for their production, the government's take is also zero.

So far, this is logical and easy to understand. Equally comprehensible is the next step in this analysis, which is that any government tax rate greater than zero and less than 100 percent will yield some revenues. This can also be seen from Chart II. You will notice that, the way the curve is drawn, it is possible to obtain roughly the same revenues from two different tax rates. The first (A) represents a high tax rate and low production, while the second (C) represents a low tax rate and high production. Obviously, by moving further away from 100 percent tax rates on the right side and zero tax rates on the left side, the government will approach a point at which revenues are maximized. This point can be seen on the chart as point B. Any movement past point B, whether it is lowering or raising the tax rate, will reduce revenues.

The question then becomes what tax rate corresponds with point B. Point B is not 50 percent as might be implied from the symmetrical nature of the curve, although it can be. Followers of the Laffer curve would prefer to observe that point B is a variable number, the point at which the electorate desires to be taxed. Laffer's analysis suggested that our tax rates are so high that we are on the descending portion of the curve thereby producing less than maximum tax revenues to the government. He thought that cutting tax rates, say

CHART II
LAFFER CURVE



from A to B, would cause revenues to rise toward their maximum level. It is this curve that formed the basis for the tax cuts enacted by the Reagan Administration in 1981.

Notwithstanding the geometry as well as the economic logic behind it, the facts are that this plan did not work. Rather than raising revenues to help erase Washington's budget deficit, the tax cut slashed revenues and produced the 12-digit deficits that have been a hallmark of our economy for the past few years. Economist Laffer and his followers claim that other factors prevented his curve from working, such as the fact that the tax cuts were spread out over several years, the tight money implemented by the Federal Reserve, the lack of a gold standard, and so forth. However, most economists dismiss these arguments and concentrate instead on what they consider to be a more fundamental flaw in this kind of analysis. It is their belief that current tax rates are well to the left of the maximum point, say C, rather than to the right, at A, and, as you can see from the chart, cutting them to, for example, D, permanently lowers the revenue base rather than increases it. This would seem to be a reasonable argument. For one thing, tax rates average only about 24 percent. For another, 4½ years have gone by since taxes were cut and there is no sign that revenues are

rising any faster than they ordinarily would at this stage of a business recovery. And since they are climbing from a lower base while spending levels have been maintained, the deficit has remained huge.

The Phillips Curve

So far the score is tied. We have seen that one curve, the J curve, appears to be working as usual, while the other, the Laffer curve, is not. Now we come to the third curve, the Phillips curve, whose success appears to be a combination of the two previous curves. That is—the Phillips curve used to work, did not seem to for a while, and now appears to be operative once again.

Although the Phillips curve is used today to describe the seemingly inverse relationship between unemployment and inflation, in its original form, it dealt with changes in the wage rate and the unemployment rate. A.W. Phillips, in a study published nearly 30 years ago, found that there was a stable nonlinear inverse relationship between changes in the wage rate and the unemployment rate in the United Kingdom. What is more, he found that this relationship seemed to apply for a period of almost 100 years (1861 to 1957).

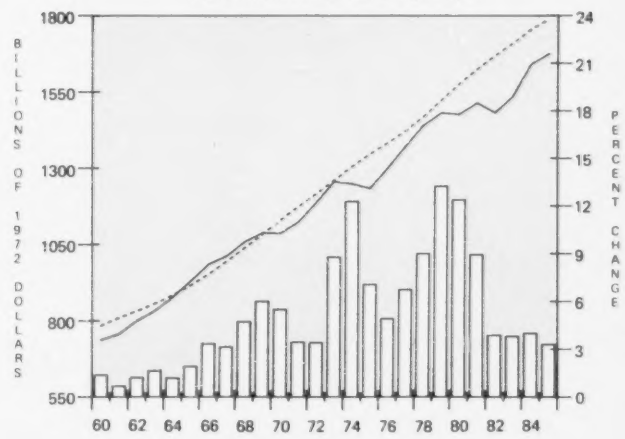
In plain English, Phillips observed that in periods when unemployment was low, the percentage increase in money wages tended to be high. By contrast, when unemployment was high, the percentage increase in money wages tended to be low. This makes sense, since labor's bargaining position is directly affected by how many of its members are working and how many are not. When there are few people out of work, labor is in a better position to demand higher money wages than when a lot are jobless.

Since this study was published, other economists conducted similar studies using U.S. data. What is more, by assuming constant markup pricing on unit labor costs, these economists were able to transform the Phillips curve into a tradeoff between price (rather than wage) inflation and unemployment rates. They did this because both inflation and unemployment are matters of public policy and it was thought that if a tradeoff existed between unemployment and inflation, policymakers could pick some acceptable combination of the two. Indeed, this was the basis for the economic philosophies of the two major political parties in the United States. The Democrats tended to be more concerned about unemployment than inflation while the Republicans seemed to be more worried about inflation than unemployment.

However, just as sides were being chosen, the tradeoff stopped working. What appeared to be a pretty good inverse relationship between unemployment and inflation from the mid 1950s to the late 1960s, seemed to fall apart in the 1970s, in the wake of such major developments as sharply rising oil prices, a change in the composition of the labor force toward greater participation by women and teenagers, more aggressive union behavior, and greater disincentives to work as a result of government income maintenance programs. Supporters of the Phillips curve argued that the tradeoff still existed, only it worsened—in other words the curve shifted to the right. Others pointed out that what is true for short-run periods in the U.S. is not necessarily true for the longer run.

If you look at Chart III, you will see that inflation does seem to respond to utilization pressures within the economy. Instead of the unemployment rate, I prefer to use the gap between actual and potential real GNP. Looking at the Phillips curve this way, you can see that inflation does worsen when the economy is at or above potential and inflation does subside when a gap opens up in the form of unused resources.

CHART III
ACTUAL REAL GNP (LINE) VS. POTENTIAL REAL GNP (DOT) VS. 12-MONTH PERCENT CHANGE IN CONSUMER PRICE INDEX (BAR)



Therefore, it would seem that, if one uses as a proxy for the unemployment rate the gap between actual real GNP and potential real GNP, one can see that price pressures do respond to the degree of slack in economic activity. Near-full utilization of resources helped drive the inflation rate up in the late 1970s. This was brought down by two back-to-back recessions, which resulted in considerable unused resources. Obviously, it should not be inferred from this that it is possible to base policy decisions on the Phillips curve. However, policymakers should understand that the rules of economics still work pretty much the way they used to: To bring down high inflation, one must create economic slack and if the economy approaches full utilization of resources, the chances are inflation will worsen.

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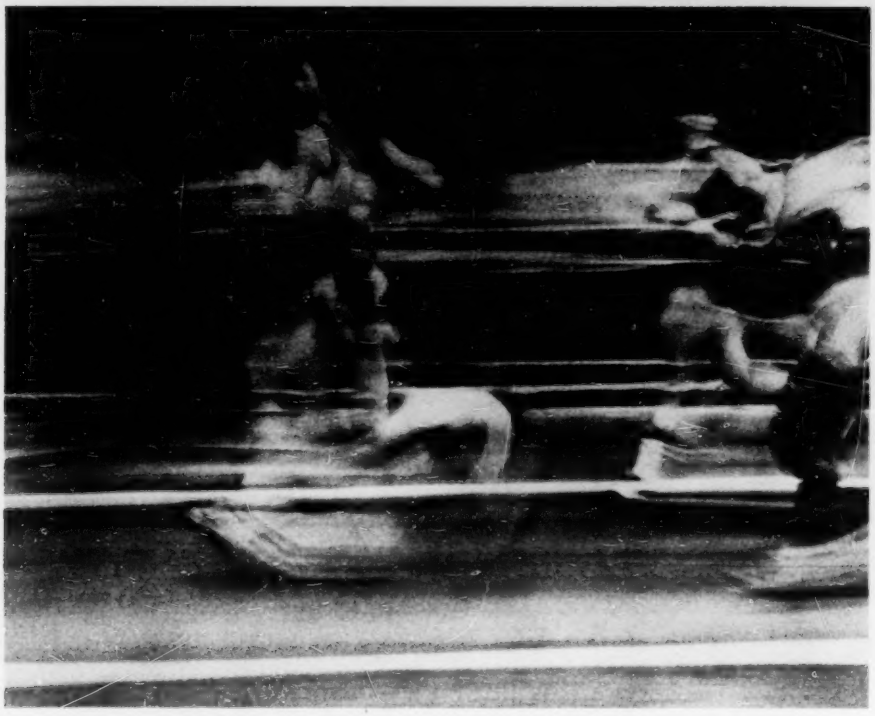

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